VIRGIN ISLANDS TELEPHONE CORPORATION
2004 ANNUAL TARIFF FILING

Description and Justification

Introduction

The Virgin Islands Telephone Corporation, d/b/a Innovative Telephone ("Innovative" or the "Company") is filing this description and justification in compliance with the rules and regulations of the Federal Communications Commission (the "Commission" or "FCC"), 47 C.F.R. Section 61.38, as well as the Commission's requirements for tariff support materials to be filed with the 2004 annual access tariff as specified in the Order of the Wireline Competition Bureau, DA 04-1048, released April 19, 2004. The purpose of this description and justification is to provide the Commission with supporting evidence for the Company's June 16, 2004 tariff filing for traffic sensitive switched and special access services.

Background

Innovative is an incumbent local exchange carrier providing regulated telephone services within its franchised service territory of the United States Virgin Islands ("USVI"), an area that includes the islands of St. Thomas, St. Croix, St. John and Water Island. For the tariff period of July 1, 2004 through June 30, 2005 ("TY2004/2005" or "tariff year"), the Company anticipates demand of 409,952,000 access minutes of use and an average of 71,681 access lines.

The U.S. Virgin Islands are located in the Caribbean more than 1,000 miles from the Florida coast. Historically, the mainstay of the USVI economy has been tourism, a sector that periodically is affected by tropical storms and hurricanes, as is island commerce in general. In recent years, the USVI has endured a number of serious storms that significantly affected the islands' economies and infrastructure, including the Company's telecommunications network. These storms include Hugo in 1989, Marilyn in 1995, Georges in 1998 and Lenny in the late fall of 1999. Through ambitious restoration efforts and an aggressive plant modernization program, Innovative has been able to restore services rapidly in the aftermath of serious storms and is fortifying its network to withstand the potential threat of storms in the future. In addition, the USVI economy, and consequently Innovative, have been significantly affected by the events of September 11, 2001, the conflict in Iraq, the overall downturn in the United States ("U.S.") economy in recent years and the current fiscal crisis of the Company's largest customer, the U.S. Virgin Islands government. In 2004 the U.S. Virgin Islands continues to experience reduced economic activity, a condition linked to the sluggish recovery of U.S. economy, lingering concerns about the safety of air travel, as well as the hostilities in Iraq and the oil sector strike in Venezuela.

While St. Thomas cruise ship arrivals have shown a modest increase in 2004, the absence of cruise ship arrivals in St. Croix have served to significantly suppress tourism activities and related expenditures. These conditions have resulted in a continuing reduction in off-island long distance demand through the wireline switched network. The relative flatness of tourist/consumer activity dampens toll demand, both from personal calls to the credit card validation calls. In addition, Innovative's service area continues to experience growth in wireless services demand to the detriment of wireline service demand. Nationwide fixed rate wireless calling plans now have been extended to the U.S. Virgin Islands, providing a no-additional-cost substitute for traditional toll calling by visiting tourists.

Summary

Table 1 below shows that Innovative's composite access rate will increase by 2.53 percent over the current rate, from $0.009425 in TY2003/2004 to $0.009433 in TY2004/2005. The components of this proposed increase are shown in Table 1. The proposed increase in TY2004/2005 access rates primarily is due to an increase in the local switching rate. All other switched and special access rates, with the exception of a small 1.34% increase in the tandem switched termination rate, are reduced significantly with this filing. As discussed below, the modest proposed increase in the composite access rate for TY2004/2005 reflects increased costs as the result of an aggressive network modernization effort and an anticipated reduction in access demand for TY2004/2005.

Table 1

VITELCO Composite Rate Comparison

Current Composite Rate versus Proposed 2004/2005 Composite Rate

	Element	Current 7/1/03	Proposed 7/1/04	% Change
1	Local Switching	0.003307	0.003887	17.52%
2	Tandem Switching	0.004260	0.004057	-4.76%
3	Tandem Switching Termination	0.001179	0.001195	1.34%
	Total	0.008746	0.009139	4.49%
4	Tandem Switched Facility	0.000030	0.000027	-11.24%
5	ALOH	22.630033	19.95249821	-11.83%
	Line 4 * Line 5 Total	0.000825	0.000700	-21.74%
6	Composite Rate per Minute	0.009425	0.009670	2.53%

Tariff Year Costs

Innovative's projections of TY2004/2005 costs are based on the Company's 2004/2005 budget figures for operating expenses and capital expenditures. During the 12-month period from July 2004 through June 2005 Innovative plans $17.9 million in capital expenditures and plant additions. These plans are part of an aggressive plant modernization program that encompasses several categories of plant operations. Within recent years the Company has brought into service two new DMS-100 host switches. This switch modernization and expansion program continues during the tariff year with the installation and upgrades of several remote switching units. Innovative also is in the process of upgrading feeder plant, distribution plant and interoffice transmission facilities. An important aspect of the planned program is the conversion of existing aerial plant to buried and underground plant as part of the continuing effort to fortify the network in the face of expected active storm seasons in the next few years.

Another important part of the Company's modernization program is the expansion of facilities on the island of St. John, including the expansion of transmission facilities and feeder/distribution routes. Innovative also continues place fiber optic cable capacity between each of the U.S. Virgin Islands in order to increase network reliability and service quality by replacing existing radio routes, by providing needed redundancy for inter-island routes and by increasing bandwidth capacity. These modernization expenditures will provide better service quality, reliability and increased efficiency and lower unit costs as network utilization increases with the growth in demand.

The Company's ambitious capital program summarized above, in combination with routine plant upgrade and replacement programs, demonstrate Innovative's continuing commitment to provide up-to-date and reliable services to its end user and access customers in the most efficient manner. These efforts are combined with a continuing operating expense control program to ensure that the Company's rates are and will continue to be as low as possible given the characteristics of the U.S. Virgin Islands operating region.

It is important to note that this filing proposes to significantly reduce special access rates and entrance facilities rates from between 12.5% to 17.2%. The reductions reflect increased efficiency in network operations and anticipated increase in demand special access circuits, particularly, high capacity circuits.

The expense projections for the tariff year presented here are based on the Company's calendar year 2004 operating budget. The anticipated change in operating expenses before income taxes for calendar year 2004 over 2003 was translated to a monthly growth rate that was assumed to continue through the first six months of 2005. The tariff year cost study incorporates expected increases in investment and expenses over past year 2003 levels.

Tariff Year Revenue Requirements

The projected total access revenue requirements for the tariff year, including special access, will increase by 3.65% from $5,974,181 in tariff year 2003/2004 to $6,204,942 in tariff year 2004/2005. This growth reflects increases in the local switching, information and tandem switched transport revenue requirements and a reduction in special access revenue requirements.

Tariff year revenue requirements were determined through the application of the Commission's jurisdictional separations rules (Part 36) and access charge rules (Part 69). The Part 69 process identified tariff year revenue requirements for switched elements and for special access service as a whole. Steps were taken to further segregate, where necessary, the revenue requirements into specific access element categories.

The TY2004/2005 revenue requirements also reflect the conditions of the FCC Order 01-304 which require that certain adjustments be made to the costs.

The first adjustment shifts 30% of local switching costs to common line costs. This adjustment is made to the revenue requirements from the tariff year cost study results. The results of this adjustment are shown in Schedule 1, attached hereto.

The second adjustment requires that transport revenues be reduced and spread over all access elements to eliminate the TIC charges that are included in the transport rates. In developing the access rates the TIC revenue adjustment is set to zero because the transport revenues are higher than the transport costs. In Schedule 1 adjustments are made to the transport rates to ensure transport revenues equal transport costs.

Tariff Year Demand

Innovative projects a reduction in switched access minutes of –4.29 percent for the tariff year over calendar year 2003. The negative growth in access minutes in addition to the increase in revenue requirements are reflected in the composite increase in access rates for TY2004/2005. The demand projection reflects not only the historical trend in demand, but also the previous year's projection error. In other words, the statistical forecast of demand for the tariff year is adjusted to account for the forecast error that was made in the previous year's tariff filing.

Schedule 6 contains the historical demand and demand forecast which is adjusted for the previous year's projection error[1]. The historical data for access minutes are monthly minutes of use for January 2003 through April 2004. The historical trend in demand shows that the access minutes will continue to decrease in the tariff year as compared to 2003.

In addition to the impacts of economic conditions and competition, access demand will continue to be affected by a fiscal crisis faced by Innovative's largest customer, the U.S. Virgin Islands government. For the fiscal year ended June 30, 2003, the USVI government is experienced a budget deficit of more than $140 million, or over 30% of the total operating budget. As a response to this budget crisis, the government has curtailed services and required unpaid furloughs of government employees. The direct impact will be a reduction in government-related access demand and the ripple effect of a reduction in government demand of island sector

[1] An analysis of projected access demand of for tariff year 2003/2004 versus actual demand shows that Innovative over-estimated the Company's demand. The percentage difference is used to adjust demand for the 2004/2005 tariff year.

goods and services, as well as the reduction in telecommunications demand from affected government employees and affected commercial sector companies and their employees.

The demand forecast is developed by estimating the compound rate of growth in demand over the January 2003-April 2004 period. The estimated growth rate and the demand projections for access minutes are shown in Schedule 6. Based upon these estimates the Company projects a decrease in 2004/2005 access demand in the tariff year versus 2003.

The Company projects a reduction of 4.29% in access minutes in the tariff year, July 2004-June 2005. The reduction reflects several conditions in the US Virgin Islands. First, the continuing trend of migration of dial-up Internet access minutes to local jurisdiction calling to Internet Service Providers ("ISP's") premises on the U.S. Virgin Islands local switched network. Second, Personal Communications Services ("PCS") and associated "one-rate" plans are steadily making inroads and gaining market share in the U.S. Virgin Islands in 2003. This development will further erode the Company's access minutes due to routing PCS traffic destined off-island through PCS provider facilities to Puerto Rico for eventual routing to interstate/international destinations.

Access Rate Development

Innovative's access tariff includes rates only for traffic sensitive switched services and special access services. The Company continues as a participant in the Common Line Pool of the National Exchange Carrier Association ("NECA") and applicable carrier common line access rates are found in NECA Tariff FCC No. 5.

All rate development calculations comply with the Commission's access charge rules and related procedures defined in the Local Transport Rate Restructure, Access Reform and MAG Orders. Proposed special access rates reflect overall changes in expected special access revenue requirements in the tariff year.

The access rates proposed by Innovative for the 2004/2005 tariff year are developed in Schedules 1 through 5. Schedule 1 calculates the adjusted revenue requirements for the access categories and also develops the final rates for transport services. Schedule 2 develops the traffic sensitive rates for local switching, directory information surcharge and directory assistance. Schedule 3 develops the rates for tandem switching; Schedule 4 develops the interim rates for tandem switching termination and facility and the entrance facility rate, and Schedule 5 develops the special access rates.

Table 3 below compares the Company's proposed access rates for TY2004/2005 with the current rates. Access rates in the 2004/2005 tariff year will fall for voice grade and DS1 entrance facilities, tandem switching, tandem switched facilities and special access. Rates for tandem switched terminations and local switching will increase. The decline in certain tandem switched transport rates reflects the adjustments for the over-recovery of transport costs for this category of services. In addition, a change in the routing of the Company's 800 access traffic results in a lower average-length-of-haul for access traffic, thus reducing the effective tandem switched facility access charges on a composite basis. The increases in the other access rates are consistent with the projected growth in access costs and the decrease in forecasted demand. The increase in the tandem switching rate reflects the assignment of all trunk and multiplexor revenue requirement to tandem switching, instead of only a portion of these costs.

Table 3
Virgin Inslands Telephone Company
2004 Annual Access Tariff Filing
Comparison of Current Rates and 2004 Proposed Rates

Ln	Rate Element	Current 1/	Proposed 07/01/2004 2/	% Change
1	Local Switching	$ 0.003307	$ 0.0038868	17.53%
2	Entrance Facility - DS1	$ 145.460000	$ 120.4275329	-17.21%
3	Tandem Switching	$ 0.004260	$ 0.0040571	-4.76%
4	Tandem Switching Termination	$ 0.001179	$ 0.0011949	1.34%
5	Tandem Switched Facility	$ 0.000030	$ 0.0000266	-11.24%
6	Channel Termination - Voice Grade 2-wire	$ 34.130000	$ 29.8654755	-12.49%
7	Channel Termination - Voice Grade 4-wire	$ 55.370000	$ 48.4500450	-12.50%
8	Channel Mileage Termination Voice Grade	$ 48.260000	$ 42.2250460	-12.51%
9	Channel Mileage Termination - DS1	$ 326.870000	$ 286.0135561	-12.50%
10	Channel Mileage Facility	$ 0.450000	$ 0.3926318	-12.75%
11	Channel Mileage Facility - DS1	$ 2.430000	$ 2.1268457	-12.48%

1/ Source: Tariff F.C.C. No.1, Section 17, Effective July 1, 2003
2/ Source: 2004 Tariff Filing, Rate Schedules